

Statement Before the Task Force on
Entitlements, Uncontrollables, and Indexing
of the House Budget Committee

by

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Mr. Chairman and task force members, I appreciate the opportunity to testify before you today on H.R. 3790, the proposal introduced by Representatives Jones and Campbell to reduce the indexing in the income tax and in non means-tested entitlement programs by 2 percentage points each year during the 1985-1990 period. Before I comment on the specifics of the bill, let me review the context in which it is being considered.

Under current tax and spending policies, we face the prospect of unprecedented large deficits for the foreseeable future--ones that will almost surely be in excess of \$200 billion or 4 percent of GNP towards the end of the decade. Furthermore, stronger than expected economic growth will do little to reduce these longer term deficits. They will be increasingly structural in nature--reflecting a fundamental and growing imbalance between current tax and spending policies that will persist even in a full employment economy. Therefore, these deficits can only be remedied through legislative action. While I do not share the view of many economists that these deficits pose a grave threat to the current recovery, I do believe they represent a serious problem for the long run health of the economy which requires major legislative measures that should not be delayed beyond 1984.

The danger is not so much that the recovery will soon falter, since the increasingly stimulative fiscal policy inherent in the growing structural deficits should more than offset any effects of the inevitable high interest rates. Rather, it is that the recovery will be extremely unbalanced, characterized by high levels of consumption and defense spending and low levels of business investment and exports. This mix will impede rather than enhance the longer run growth of the economy that presumably was the target of the Reagan Administration's supply-side tax cuts.

To avoid this outcome, the structural deficit should be gradually reduced over the remainder of this decade. An appropriate intermediate goal for the structural deficit would be about one percent of GNP, which is similar to the level experienced during the 1960's. To attain such a target over a five-year period would require tax increases and reductions in program spending that would exceed \$125 billion annually by FY88. We need to act quickly because you cannot get from here to there without significant disruptions if sizeable adjustments are suddenly implemented.

Given the magnitude of the desired deficit reduction, it is clear that substantial action will be required on all three major fronts--tax increases, further restraint for domestic program spending and a scaling back of the planned defense build-up. Complete implementation of the FY84 Congressional budget resolution would still leave us with a structural deficit well in excess of two percent of GNP in FY88. Even the addition of the full measure of the President's proposed domestic spending cuts would not be sufficient to achieve the one percent target.

H.R. 3790 fulfills a pressing need since it incorporates broad measures affecting both the revenue and spending sides of the equation. Proposals such as H.R. 3790 and ones recently put forward in the Senate, such as Senator Dole's deficit reduction package, that link tax increases and spending cuts offer hope for constructive solutions to the current budget dilemma. However, as I describe below, H.R. 3790 as presently formulated raises several serious issues.

The tax provisions of H.R. 3790 would reduce the indexing provisions for the personal income tax, due to take effect in 1985, by 2 percentage points below the called-for CPI adjustment. By FY90 this provision is estimated by the CBO to yield \$31.3 billion annually, which would represent a little less than a 3 percent increase in the federal tax burden (federal taxes as a percent of GNP) and a 2 percent increase in the total tax burden above where current policies would place them.

I favor the principle of indexation of the personal income tax system. However, under the current circumstances it appears to be a luxury we cannot yet fully afford, given the current structure of the tax system. Some reduction in this indexing feature is a reasonable way to raise a portion of the much larger total tax increase that will be needed to address the deficit problem. It is relatively neutral in its distributional effects and spreads a small burden widely over the entire taxpaying population.

However, I would note two things. First, for reasons of both equity and efficiency, it would be preferable to rely entirely upon base broadening measures to raise any additional revenues. The efficiency and equity of many tax expenditures are highly questionable. Just as direct outlay programs have been subjected to close scrutiny in the search for spending restraint, so should current limitations to taxable income. These special subsidies are much less defensible in light of the compelling national interests at stake in the search for major deficit reduction measures. A reduction in tax indexation has the effect of raising marginal tax rates slightly. My judgment that a reduction in tax indexation is desirable is predicated on the assumption that it is simply not feasible to achieve all of the needed revenue increases over the next five years through base broadening measures. However, every effort should be made to emphasize such measures.

Second, while taxpayers with higher incomes have realized a sizeable reduction in their tax burdens over the past three years, lower income taxpayers have not. In fact, the lower income population has incurred an increase in its tax burden since 1980 as sales, excise and payroll taxes have risen, inflation has pushed their earnings up into a range where a much greater portion of it is liable for income taxes (since recent tax cuts did not affect the level of personal exemptions and the zero bracket amounts), and the real value of the Earned Income Tax Credit has been eroded. Whether indexation is reduced or not, some steps ought to be taken to offset the rising tax burdens for this population, who have also borne the brunt of the spending cuts. One that recommends itself is to increase and then index the Earned Income Tax Credit.

Now let me turn to the spending features of the bill. H.R. 3790 would also reduce the indexing of non means-tested entitlement programs by 2 percentage points below the normal CPI adjustment starting in 1985. The CBO estimates that this would save \$25.3 billion in outlays annually by FY90. The vast majority of these savings would come in the social security program. Lesser amounts would be realized in military and civil service retirement programs.

If one accepts the notion that further domestic spending restraint is an essential ingredient of any major deficit reduction scheme, then some sort of an across-the-board COLA reduction such as this ought to be considered. Along with Medicare, these middle class entitlement programs account for about half of domestic spending and a far greater portion of its projected growth. There is simply no way to achieve substantial additional reductions in domestic spending without focusing on these non means-tested entitlements unless the remainder of the budget is to be decimated.

There are additional arguments in support of the COLA reduction. First, until recent technical changes were made, COLA's actually overadjusted for actual cost-of-living increases. Second, the beneficiaries of these programs have been largely protected from the budget cuts to date. For example, the only provision affecting the average social security recipient before the next century is the recent six month delay in the COLA adjustment which amounted to a 2 percent reduction in real benefits. In the past, the inferior economic status of the aged has led society to be far more generous in public policies affecting them relative to the non-aged. However, recent studies have revealed that the aged have achieved an economic status on a par with the rest of the population. Thus, it is not unreasonable to ask them to share equally in the sacrifices necessary to reduce the deficit.

More importantly, if retirement programs are going to contribute significantly to deficit reduction efforts this decade, COLA reductions are a fair way to accomplish this. This is because they spread the pain in small doses over large numbers of people and yield immediate savings. Adjustments in the SSI program can ensure that low income recipients are not affected.

Having extolled the virtues of COLA reductions as a general means of achieving domestic spending restraint, I must now express grave concerns about the particular form in which they are embodied in H.R. 3790. In short, I believe the particular provisions of this bill reduce social security benefits excessively relative to the revenue increase. Furthermore, the provisions reducing COLA's raise a serious issue of equity among current and prospective social security recipients.

Let me elaborate on these points by discussing the consequences of this bill for some typical families. I pointed out earlier that the increase in revenues by FY90 would reflect a rise of a less than 2 percent in the total tax burden. This will translate into a reduction in disposable income of well under one percent for the average taxpayer. Although the total deficit reduction impact of the spending cut is slightly less than that of the tax cut, it has a far more detrimental impact on disposable income of those affected, since there are far fewer program recipients than taxpayers. For social security recipients already on the rolls in 1985, the cumulative effect of six two percentage point reductions in the CPI adjustment is a real benefit reduction of about 11 percent annually by 1990. Since social security comprises a large share of the aged's income, this benefit reduction will translate into a reduction in disposable income of anywhere from, say, 5 to 8 percent for most recipients, and up to 11 percent for the unfortunate minority highly dependent on social security for income.

For recipients who newly enter the rolls between 1985 and 1990, the consequences will be less severe, since they will be subject to fewer years' reductions in their COLA. This, however, will create serious inequities among retirees with similar wage histories. In the extreme, by 1990 a retiree who has been on the rolls since 1984 will be receiving an 11 percent lower benefit than a new retiree with an identical (properly indexed) wage history.

Despite the urgent need for action on the deficit and the general desirability of COLA reductions, I do not believe that a spending cut of this nature is defensible. First, the inequity among current and prospective recipients is too great and the impact on longer term recipients too severe. Longer term

recipients, if any, are the group that we should ask to bear a less than average share of the burden, since they are likely to be more dependent upon social security income. Fortunately, there are various technical ways of addressing this problem which I urge you to consider.

Second, the reduction in disposable income for program recipients, particularly social security recipients, is much too high relative to that for taxpayers. I realize there is some superficial appeal in the symmetry of an equivalent reduction in indexing of both taxes and COLAs. But, as I hope I have made clear, the result for the affected individuals and families is far from equivalent. Even full postponement of the indexation of taxes would have less consequences for the disposable income of the typical taxpayer than would a 1 percent reduction in COLAs for the disposable income of the typical recipient.

In summary, I believe proposals to link reductions in tax and COLA indexation are a desirable ingredient of a much needed strategy to reduce projected structural deficits by 3-4 percent of GNP by the late 1980's. However, such proposals should be designed to yield both far greater aggregate savings in taxes relative to spending and a more equitable distribution of the benefit cuts among recipients than would H.R. 3790.

ERLENBORN QUESTIONS AND ANSWERS

Q: Re COLA, FAIR would allow COLA to \$10K floor with 60% over that?

A: Yes - \$10K floor indexed to CPI, plus 60% over that.

Q: Any response from OMB & OPM on savings?

A: No, not until January or February 1984.

Q: Re thrift plan, like an IRA?

A: No, going in would be fully taxed--also, matching employer contribution up to 3%.

Advantage--capital formation resulting from thrift plan available for use.

Q: Cost of thrift plan?

A: Uncertainty re extent of government employee contribution but ultimately could easily reach 2% of payroll cost (+ 80% employee participation after 5 or so years).

Q: Why offer early retirement at all?

A: It is consistent with broad practices in the private sector, everything considered.